

Germany: Beyond the two Ms of Merkel and manufacturing

Could it be different this time or will the lacklustre performance of the German manufacturing sector eventually hit the entire economy?



German Chancellor, Angela Merkel visits a car battery factory in 2017

You needn't worry if you've no reputation to lose. This seems to be the red line in the recent growth performance of the eurozone's largest economy. The sharp drop in sentiment indicators since the summer of 2018 as well as the lacklustre performance of the manufacturing sector pushed the German economy close to the recessionary territory in the second half of 2018. While concerns and risks have hardly disappeared since the start of the year, GDP growth in the first quarter surprised on the upside and could continue doing so throughout the rest of the year. Downbeat assessments of the German economy are often derived from the continuing weakness in the manufacturing sector, thereby overlooking strong domestic demand and chances that there could be life (of economic growth) in Germany after manufacturing.

Manufacturing downswing continues

At first glance, the industrial outlook is anything but rosy. New orders have been deflating since last summer and business sentiment has nosedived. Industrial production had a disappointing start to the second quarter as global trade tensions, as well as temporary problems in the

automotive sector and chemical industry, left their marks. One-off factors should have disappeared by now and even turned into temporary positives. Yet the experience of the last few years shows that there is almost always another disruptive one-off factor waiting around the corner. At the same time, the export sector also continues to suffer from the trade conflict and Brexit uncertainty.

It's not all doom and gloom

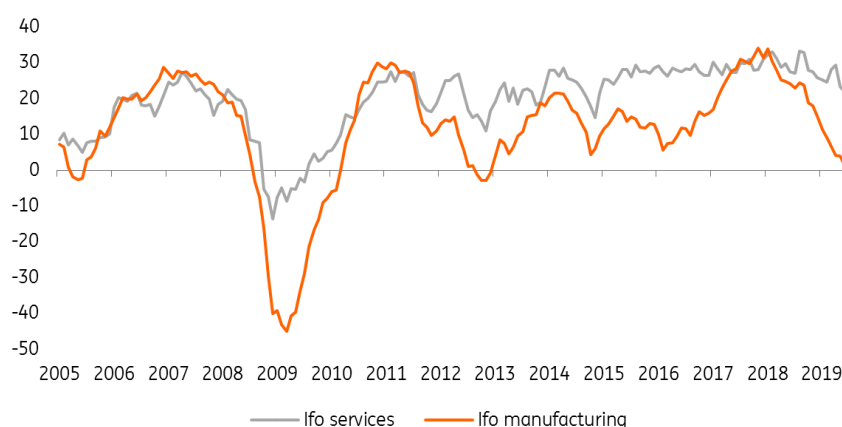
However, it's not all doom and gloom. Despite the order book deflation since last summer, businesses still report filled pipelines of assured production. In fact, German exporters almost sold as much to the UK as to China over this period. Also, the share of exports going to the US slightly increased, this could be a double-edged sword as it shows how vulnerable the German economy is to possible US tariffs. At the same time, the weakening of the effective exchange rate since September 2018 should have partly cushioned the negative impact of global trade tensions. Currently, the effective exchange rate is below its 2018-level, providing some tailwinds for exports in the months ahead.

All of this means that the industry will continue to fluctuate between, on the one hand, low interest rates, high capacity utilisation and a strong need for new investments, particularly in digitalisation, which eventually should be growth-supportive. On the other, there's disruption from trade tensions as well as structural changes in the manufacturing sector.

Beyond manufacturing

In a German context, talking about anything “beyond manufacturing” sounds crazy. Germany is an economy, in which the automotive sector - taking second and third round effects into consideration - accounts for some 7% to 8% of the total economy. Roughly one-third of all German R&D spending is related to the automotive sector. Still, it is also an economy in which more than 75% of it thrives on non-manufacturing activities. Always be cautious when economists talk about “this time could be different”, but the last five years have demonstrated that activity in both the manufacturing and services sector no longer moves in parallel.

Decoupling of manufacturing and services



Source: Refinitiv (formerly Thomson Reuters)

The reason for this decoupling could be a structural transition towards more services-driven economies. Only time will tell whether this decoupling is for real or whether the old pattern of the manufacturing sector eventually leading the service sector still holds. In any case, strong domestic demand on the back of low unemployment, high employment, higher wages and low inflation remain the best recession insurance for the German economy. In fact, the ongoing boom in the construction sector, combined with government consumption and more investments could still tilt German growth to a positive surprise this year. Only an uncontrollable negative sentiment loop would push the economy close to – if not into – recessionary territory.

Investments and politics

To move beyond manufacturing, more fiscal stimulus would definitely help. This never-ending debate on the Black Zero and why German fiscal policies cannot move towards more investments in times of record low-interest rates could finally enter a new chapter. In fact, according to our own estimates, the German government could run fiscal deficits, instead of surpluses, of around 2% of GDP every year for the next five years and the debt-to-GDP-ratio would still remain stable at 60%. Plenty of room for fiscal stimulus. However, the economic situation is not severe enough for the government to really get into action. Instead, the ongoing tension within the governing coalition makes any agreement on a significant new fiscal stimulus rather unlikely. A subtle shift towards somewhat more spending is possible, a significant game changer rather not.

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Talking of politics, the results of the European Elections confirmed our tail risk scenario of a possible fall of the government towards the end of the year. The coalition parties have not only lost further electoral support since the 2017 federal elections, but unrest in both coalition partners has also increased. The key factor to watch here will be the SPD, which again has to find a new party leader, while at the same time developing a strategy on how to regain voters, be it within or outside government.

Also, the CDU has not solved the question of who could eventually succeed chancellor Angela Merkel, which could lead to some political tensions in the coming months. With the recent successes of the Greens, any fall of the government would, in our view, lead to snap elections, not just a simple reshuffling of coalition partners. The Greens have become too strong to simply go into a government with the CDU as a small junior partner. According to the latest polls, the CDU and Greens could almost form a government of near equals. It could be a government, providing new fiscal stimulus.

Beyond the two Ms

The German economy might have lost its stellar performance but strong domestic demand is still a very powerful shield against recessionary fears. Don't count the German economy out, yet. In the longer run, the big question is what comes beyond the two M's: Merkel and manufacturing.

This article is taken from the Eurozone Quarterly, which you can find [here](#)

The German economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP	1.5	1.1	2.1	1.6
Private consumption	1.1	1.8	1.6	1.2
Investment	2.7	3.4	3.5	3.0
Government consumption	1.1	1.2	1.6	1.6
Net trade contribution	-0.4	-0.5	0.3	0.2
Headline CPI	1.9	1.7	1.8	1.8
Unemployment rate (%)	3.5	3.4	3.4	3.4
Budget balance as % of GDP	1.6	1.3	0.9	0.9
Government debt as % of GDP	60.8	58.0	57.4	55.0

Source: Thomas Reuters. All forecasts ING estimates

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